THE VALUATION PROFESSION - A BRIEF HISTORY

As a valuator I spend my professional life appraising a wide range of businesses, securities, assets and liabilities throughout the world. I am also Chairman of the International Association of Consultants, Valuators and Analyst (IACVA), a knowledge-transfer organization devoted to spreading best practices globally and making life less difficult for entities involved in and dependent on valuations.

Many of our assignments relate to financial reporting under Generally Accepted Accounting Principles, which are established by the Financial Accounting Standards Board (FASB) of Norwalk, Connecticut, USA, and its foreign equivalent, the International Accounting Standards Board (IASB), in London, England. Since November 2002, they are collaborating to make their existing standards fully compatible to ensure international comparability of financial reporting. As of July 2008, both the technical requirements, and the professional standards continue to evolve.

Accounting is a conservative profession - a hackneyed joke is that it's the second oldest - and there may be some truth to this. Before writing, before the invention and acceptance of money, even before the concept of numbers, starting around 7500 B.C., clay tokens were used in Mesopotamia to keep track of inventory in order to manage some control over one’s possessions. Those were items essential to survival: grain, animals, tools etc. all things one could see, touch, or feel - in short: tangible assets. In many ways accountants have grown more sophisticated, but that basic concept has metamorphosed almost into an instinct and still remains a sound way of covering one's derriere.

Unless Intangible Assets are acquired in a transaction, such as a Business Combination, accountants in the U.S. have traditionally excluded them from a firm's Financial Statements. Until not long ago, even when purchased, they were treated with indifference, either lumped with goodwill or totally ignored in a Pooling of Interests. Only recently did FASB and IASB introduce Standards dealing with their fair values. In this context, it is of interest to contemplate the development of our profession.

The Growth of Valuation

The need to value items reaches far into antiquity. Plato (427 - 347 BC.) described the concept of value as one of the most difficult questions. His pupil, Aristotle (384 - 322 BC.), teacher of Alexander the Great, believed that the value of an object was created by and existed only in the mind of man. In the first century, this was paraphrased by the Roman philosopher Seneca (c. 4 BC - 65) as “Res tantum valet quantum vendi potest” or “A thing is worth only what someone else will pay for it”. This can definitely be considered the origin of the Market Approach. To a large degree, Aristotle’s view is still relevant today both for taxes and financial reporting, where however, at various times the term “value” can take on different meanings.

Alas, as we are often accused, where there are accountants, can the tax-man be far behind? The Greeks and Romans, founders of modern Western culture, taxed the value of all a family's possessions, including real estate, household furnishings, even slaves. Mortgages are older, being mentioned in the Bible. All those activities required the help of valuators; unfortunately very little about them and their discipline has come down to us, although there are references to auctioneers and appraisers in classic texts.

In Europe, after the fall of the Roman Empire, the Catholic Church evolved into the dominant entity, permeating almost all thinking concerning economic subjects. Land was considered a gift from God, evidence of nature's bounty. Secular rulers - realizing the advantages of such church practices - responded by quickly adjusting to them, ruling that all property belonged either to the church or the king, who at that time was the state. Clerical and secular rulers either rented or sold land to the nobility, and from there it trickled down to ordinary folk.

It did not take long to recognize that the more productive lands could generate a higher rent or be sold for a better price. This likely marks the beginning of the concept of economic rent and the principle of future benefits, one of the main pillars of valuation theory. Another, not applicable to land but relevant to buildings and many other items, is the principle of substitution: under ordinary circumstances no one will pay more for an asset than it would cost to acquire or create another with equal or greater economic gain.

In many European countries, during the Middle Ages, the amounts charged for some goods, such as bread, were often subject to strict controls; this was based on the doctrine of the just or proper price and on the theory that value had to reflect both labor and material costs. In many instances, freely determined markets were considered impractical and prices of most things needed to be regulated. To some extent, this philosophy is still applied; for instance, until recently, electricity rates in Europe and North America were totally under the jurisdiction of the authorities.

A second of the three modern approaches to determine value is also rooted in the Middle Ages: cost of production. The "just price" was, in effect, the reproduction cost rather than an exchange value. That concept also reflected the idea that value was a quality inherent in a commodity. As children, some of us thought that a candy bar and ten pennies were synonymous.

The Valuation Profession - A Brief History

Financial Markets and Taxes

Like accounting and valuing, banking is believed to have existed before writing; some scholars think it was developed from the need for bookkeepers to explain what they were recording. As soon as there are bankers there will be financial markets. Originally they traded in foreign exchange, for example between Roman and Egyptian coins until the fall of Cleopatra, and agricultural futures such as grains and olive oil. Although it is not known when and where such activities actually commenced, they certainly existed in Rome in the first century BC. Subsequently, they added buying and selling commercial bills of exchange, currencies, government loans and annuities, as well as commodities for future deliveries.

Taxes, initially given to both gods and kings, have been with us for millennia. One of the oldest, comes from ancient Israel, where the tithe was part of the Mosaic Laws. This was basically a 10% levy on animal and agricultural products, and was paid in the product, or by part of the product. Someone who preferred to substitute money was penalized by being required to add “a fifth part” (20%) of the tithe's estimated value to the amount (Lev. 27:31). The main purpose of this tax was to support the Temple in Jerusalem and the priesthood; they ministered to the people but were prohibited from owning land.

Perhaps not coincidentally, realizing the benefits of this system, the tithe was justified on scriptural grounds by the Catholic Church. Wanting to get in on a good thing, many European rulers codified tithing into law; such funds became a major source of revenue for the state. By the sixteenth century, it had developed into an annual levy on the rent from a piece of land and was paid by the tenant to the local churches. They could, and often did, sell the rights to the tithe on a particular property for a fixed period, normally 20 years. The effect was to convert future income into a capital payment; the buyer could then resell the rights.

Looking through a list of the oldest businesses still around it turns out that - at least in Europe - many were brewers, probably as beer was often the only unpolluted drink available; the oldest, Weihenstephan in Germany, started in 1040. That seems to be a clear manifestation of the European spirit. However, Asia holds the crown; Kongo Gumi, a specialized construction company in Japan, has been building shrines since 578. The oldest manufacturer is a bell foundry in Italy started in 1000 to serve the Vatican. It is still run by the original family, having wisely adjusted to the needs of the times by melting bells down for cannon in times of war.

Finance Theory

Modern financial theory originated in the fifteenth century at two famous medieval banking houses, one in Italy, the other in Germany. According to Lorenzo de Medici “The Magnificent” (1449-1491), "The art of banking is to lend money and get it back nearly every time"; preferably with interest. On the other hand, Jacob Fugger “The Rich” (1459-1525) advised (expressed in modern terminology):

> "Divide your fortune into four equal parts: stocks, real estate, bonds and gold. Be prepared most of the time, to be in a loss position on one of these parts. During times of inflation, be prepared to lose money on bonds and make gains in real estate and gold. Periods of deflation will cause losses in real estate, but gains in bonds, while stocks will post varying results over time. When spreads in returns represent a high imbalance, it is advised that you reestablish the balance among the four parts of your fortune."

To take advantage of this advice requires a thorough knowledge of the absolute value of all your assets, i.e. a valuator. During the time of Shakespeare (1564 – 1616) and the Mayflower, tithes in England sold for between "sixteen and twenty years' purchase", creating annual yields of between 5.0% (20 years) and 6.25% (16 years). As a tithe is a perpetual charge on the rent payable by a tenant, over time, the amount would increase at the same rate as the rent. If the land was owner-occupied and no rent paid, a minimum tithe was attached to each parcel, representing an "imputed rent". In that way, a tithe was a better quality investment than a mortgage.

Much of this required quick thinking and easy communication between the parties resulting in the emergence of the broker. This traces back to thirteenth-century Paris, when the positions of "courratiers de change", literally "runners of exchange", were created by the King of France to facilitate transferring information about deals from one merchant to another.

Until the Renaissance, the idea was dominant that value, whether in use or in a sale, was an objective quality inherent in something. With the rise of humanism, the value of an object gradually came to be considered as a function of its ability to satisfy a need or desire, another important component of valuation theory.

The concept of risk was not properly understood until in 1654, two brilliant French mathematicians, Blaise Pascal (1623–1662) and Pierre de Fermat (1601–1665), developed the "theory of probability". For the first time people could make decisions, even plausible forecasts, with the help of numbers based on past experience. Over the next 65 years, the mathematical underpinnings for risk were developed, life expectancy tables created and financial markets that offered useful share and commodity price data greatly expanded.

The Corporation

That last trend was spread over much of the seventeenth and eighteenth centuries spurred by the emergence of the business corporation, originally called a "joint-stock company” with a Royal

Charter. The first, the Muscovy Company, was founded in London in 1553 to trade with Russia and remained active for 364 years - until the 1917 Revolution. Corporations came to the United States in 1607, when the Virginia Company, also based in London, established the Jamestown Colony. Although the colony eventually thrived, the firm failed and in 1623 became insolvent. One year later, its charter was revoked and the colony passed to the Crown.

While the Virginia Company did not succeed, others, in several European countries, prospered: The (English) East India Company eventually ruled India, The (Dutch) East India Company (VOC) controlled the spice islands (now Indonesia); The Bank of England (nationalized only in 1946) and The Hudson's Bay Company, which dominated the fur trade and governed western Canada until 1870; its shares traded from 1670 to 2006, when it was privatized. By 1710, active stock markets existed in London, Paris and Amsterdam. There were highly speculative bubbles during 1720 in Paris (The Mississippi Company) and London (The South Sea Company), as greedy financiers sought profits by exchanging stock at a premium for government debt, offering greater liquidity. In both cases, the shares had spectacular collapses, in many countries those irregularities it led to the introduction of market regulation.

From 1723, until Napoleon occupied the Netherlands in 1794, there were close financial links between the London and Amsterdam markets in spite of the slow communications. Stock prices for VOC and major British enterprises, such as The Bank of England, The East India, South Sea and Hudson's Bay Companies were reported at least weekly in an Amsterdam newspaper. These changed to reflect new information, which, alas, was often based on rumors, as speculators reacted to and - like today's traders - affected market prices for the stocks. During those years, a plethora of pamphlets lamented the unpredictability of the market. Some things never change. Look at the mess oil speculators have made today!

Brokers and investors during that period became increasingly sophisticated. The first known example of the ever proliferating "investment self-help" literature was published in London in 1726. "The Money'd Man's Guide or the Purchaser's Pocket Companion" by Richard Hayes discussed the value of stocks according to their discounted stream of future dividends and included tables showing the appropriate discount factors for different interest rates and time horizons. Investors engaged in cash trades, futures contracts, even options. They sold short, obtained credit, formed diversified portfolios and were able to make futures' sales of commodities, enabling them to hedge inventories, as for instance, cotton.

The concept of value, representing the benefits generated or the ability to satisfy need, started to be accepted with "The Wealth of Nations" by Adam Smith, published in 1776 – a year better known for Thomas Jefferson's great document – that marked the beginning of modern economics. He separated economic value into "value in use" - "the utility of the object for human purposes", and "value in exchange - the ability to "induce people to pay other valuables for the use of them". This distinction is still important in interpreting Fair Value in the various accounting standards. Smith's emphasis was on cost as the basis of value, which under the circumstances was not unreasonable. To him money was merely an instrument of exchange, a "wheel of trade".

It was not until nearly a hundred years later in 1849, that an unsung German, Martin Faustmann (1822 – 1876) developed the last pillar of valuation theory. He established, originally for forests, then an essential resource for shipbuilding, that the value of an asset was the present worth of its future returns; the Faustmann formula was still being used by the forest industry in the 1990s. His concept was codified as the Discounted Cash Flows method, for valuing mines and mineral reserves, by H. D. Hoskold of England in his 1877 book "The Engineer's Valuing Assistant".

The Rise of the Accountant

Except for accurate financial data, by the end of the eighteenth century most elements of modern valuation and corporate finance theories were in place; the final step is to be credited to the professional accountant. Modern accounting was first described in 1494 by Luca Pacioli (1446 – 1517) a friend of Leonardo da Vinci (1452 – 1519). But by the 1800 census, only twelve individuals in London claimed the title "accountant". As business became more complex over the decades, their role grew and by the 1870s, nearly all characteristics of the present profession existed in the British Empire and the U.S.

In the 1880s, national regulatory organizations were created in Britain (Chartered Accountants), and the United States (Certified Public Accountants). Similar associations followed throughout much of the commercial world. Auditing formed the basis for the profession, but it was not until 1934, with the establishment of the Securities and Exchange Commission (SEC), that annual audits were required of all public companies in the United States; this did not become law in Britain until 1948.

Before the 1929 crash there was no codification of Generally Accepted Accounting Principles (GAAP) anywhere; therefore the SEC turned to the AICPA, which in 1936 set up its Committee on Accounting Procedure. For the next 23 years, until 1959, this body was responsible for U.S. financial accounting and reporting standards. The Accounting Principles Board (APB), also affiliated with the American Institute of Certified Public Accountants, then took over the task. In 1973 it was replaced by the Financial Accounting Standards Board, an organization that prides itself on its independence from all other business and professional associations as well as from governments. In the same year the rest of the world created its own organization, the International Accounting Standards Committee to represent the national accounting bodies of most European and Asian nations; it has since been superseded by International Accounting

Standards Board.

Finally, in the 1990s valuation got the international respect it merited, when the 1997 Nobel Prize in Economics was awarded to a Canadian Myron Scholes (1941 -) and an American Robert Merton (1944 -) for the creation of the Black-Scholes Option Pricing Model. Unfortunately Fisher Black (1938 – 1995), also an American, its originator was not eligible as he previously passed away. This Model inaugurated the Formula Approach, which is gradually gaining general acceptance.

Today, especially in North America, accounting and valuation are frequently practiced by the same individuals adopting different viewpoints. As accountants we look back to understand “what has happened”, as valuators we look foreword to contemplate “what is likely to happen”. The making and rewriting of pronouncements on Fair Value by FASB and IASB means that the situation is still fluid; especially the question of who, accountants or valuators, is to supply the necessary guidance with respect to implementing their concepts. In the past, both Boards mainly reflected the thinking of the English speaking countries. Now they also include the views of other nations.

Regulating the Profession

The need to consider current values in Financial Statements has been talked about for many years. In the 1970’s some of us experimented with “current cost accounting”, using various indices. This trend accelerated with FASB and IASB, introducing the concept of Fair Value to partially replace original cost on Balance Sheets. As a result, financial professionals must familiarize themselves with the approaches, methods and techniques of the valuator, which over the last few decades has grown to be a significant discipline.

In 1932, the American Society of Appraisers (ASA) was founded to introduce professional standards in all valuation disciplines. This was followed by several other certification bodies, the Canadian Institute of Chartered Business Valuators (CICBV-1971), The Institute of Business Appraisers (IBA-1978), and IACVA’s US Charter, the National Association of Certified Valuation Analysts (NACVA-1990). As a group, these organizations and the AICPA have transformed business valuation into a profession supplying an essential service. In 1987, the Appraisal Foundation was established by the US Congress. This body promulgates the Uniform Standards of Professional Appraisal Practice (USPAP), which is mainly applicable to real estate.

In spite of efforts to streamline approaches, valuation standards remain somewhat fragmented. In the U.S., the established groups (ASA, AICPA, IBA and NACVA) have formed the North American Valuation Standards Board to harmonize standards. In the rest of the world, this is handled by the International Valuation Standards Council (IVSC), a United Nations organization with participants from 54 countries. While maintaining their own standards in the USA, outside it, both IACVA and ASA have adopted IVSC Standards.

FASB and IASB are continuing to coordinate international financial reporting. In addition, The CFA Institute, representing 70,000 Chartered Financial Analysts in the worldwide investment industry, has issued valuation guidelines geared to the venture capital and private equity markets in an attempt to promote transparency. Similar action has been taken by associations in Australia, Britain, the Eurozone, France, adding some of its own, and the United States. Each of these is rather inward looking as none of them appears to have taken into consideration established valuation standards and practices outside of their particular markets.

This patchwork of business valuation standards is both daunting and in conflict with the efficient allocation of capital. In many cases, the result for valuators, who are also professional accountants, is a clash between the various sets of standards. This is especially true in the U.S., where, pursuant to the Sarbanes-Oxley Act, the SEC is also involved, and is currently considering issuing its own valuation standards.